1812

THE NATIONAL CITY BANK OF NEW YORK

1950

Monthly Letter on

Economic Conditions Government Finance

New York, February, 1950

General Business Conditions

THE outlook for industrial activity and employment at the present time would be considered very satisfactory if the menace of coal shortage could be removed and the Chrysler strike ended. Despite a few soft spots, January business on the whole has been good, and with the backlogs carried over from the old year most industries have orders on hand or in prospect to warrant high operations for some time to come. The trend of the production indexes is upward, except as strikes may interfere; in December the Federal Reserve Board's index was 178 (1935-39 = 100), a rise of 12 points over the steel strike low in October. When the January figures are in they are expected to show another gain.

A feature of the month's news has been the heavy buying at the seasonal merchandise shows, particularly in furniture and household goods. The demand for goods of this kind illustrates several influences which are at work in the general situation. First, it shows a greater confidence in the Spring outlook than was generally felt a year ago. Second, it reflects improved market positions, due to curtailment of output and reduction of inventories in 1949, and sustained consumer buying power. Finally, it demonstrates the strong support that is given directly to many businesses, and indirectly to all, by the phenomenal construction activity that is now under way.

Final estimates of the Department of Commerce place the number of new dwelling units started in 1949 at the new all-time high of 1,019,000. The record was due to the unseasonally high volume of building in the last three or four months of the year, and the momentum is carrying into 1950, for residential contract awards in the first three weeks of January were 129 per cent greater than in the same period last year, according to the Dodge reports. These houses have to be equipped and furnished. New streets and new services — utilities, stores and schools — have to be provided for them. These demands have been powerful influences supporting and prolonging the recovery.

Automobile Output Cut

Automobile output has been cut some 30,000 to 35,000 cars a week by the strike against Chrysler. The Chrysler management is ready to provide for its employes $100 a month total pension and old-age insurance benefits upon retirement, which conforms to the pattern set in the steel and other cases, and which was the main issue in the negotiations. Hence most observers would conclude that the strike is over matters which to the workers must seem of little consequence as compared with their loss of pay, and that it will rapidly become unpopular with them. Nevertheless, the unions strive to break old patterns and set new ones, and its duration is unpredictable. When it ends, automobile assemblies will rise again, probably to all-time record levels. The confidence of the manufacturers in the strength of their market next Spring is undiminished.

Steel producers are hard pressed to satisfy current demand and at the same time make good

CONTENTS

the shortages in working stocks caused by the strike last Fall. Textile mills are running on good-sized unfilled orders, and in some lines forward orders booked in January have added to the backlogs.

The Coal Situation

The position of the industries as described seems to promise a further rise in production, but whether the promise is realized now depends upon the coal supply. The first effect of coal shortage on the steel industry appeared in a small downturn in operations during the last week of January. Passenger service on coal-burning railroads has been curtailed. The electric power companies, fortunately, are mostly well stocked with coal, but among manufacturing and domestic consumers shortages are imminent.

The best assurance that coal shortages will not become so acute as to paralyze industry is that the country cannot endure a breakdown of production and transportation, and cannot tolerate policies and practices which would cause it. The law recognizes that the public interest is paramount and provides for its protection when it is endangered. Unless Mr. Lewis brings about a resumption of full time mining himself, President Truman may properly be expected to take action to bring it about, as far as recourse to law can do so. On January 31 he asked miners and operators for a seventy-day full production "truce", while a fact-finding commission to be appointed by him investigates and reports.

Of course the fundamental questions raised by the coal situation will remain even if mining is resumed promptly. The main question is whether a labor union monopoly, with all the power to disregard the public interest that goes with it, should be permitted to exist, and if so how it should be regulated and its power abridged. The second question is whether the specific acts and policies of the union are tolerable.

The Three-Day Mine Week

In all labor history there have been few parallels for the action of Mr. Lewis in requiring the bituminous mines to operate on a three-day week, regardless of the prerogatives of management and of the variations in the operating and marketing conditions and the cost of production of the separate coal companies. It is undeniable that the bituminous coal markets in recent months would not have absorbed full production by every possible producer — although that is a situation for which Mr. Lewis, by constantly forcing up costs and prices, bears considerable responsibility — but it is very much in order to ask by whom the curtailment should have been made when curtailment became necessary.

In free competitive markets the producer who has to shut down is the high-cost producer who, as demand slackens and prices soften, finds that he can no longer compete with better situated and more efficient rivals. If the public interest is to be served and industry is to continue strong and healthy, this is precisely where the curtailment should occur. For it means that the companies which serve the public best in terms of quality, price or convenience, will get the public's business. Other things being equal, production will be in the hands of those with the lowest costs. Under this system the incentive is to reduce costs and improve productive efficiency, in order to gain public patronage and to hold a strong and secure position in the market. Investment in machinery and equipment and superiority in management are rewarded.

From the standpoint of the public interest, the steady lowering of the real cost of production, in order to make more and better goods more cheaply in terms of energy and effort, is the source of all economic progress and all improvements in living standards. Any action which decrees that curtailment and adjustment of production, when necessary, shall be made equally by all producers, irrespective of their abilities and costs, strikes at the heart of progress.

Too Many Miners

Both management and the unions concede that there are too many coal miners trying to make a living out of the industry for its present market. But Mr. Lewis says, "If we are going to starve . . . we will just all starve together." Mr. George H. Love, for the operators, says on the other hand that while there are too many pick and shovel miners there are not enough skilled workers for mechanized mines. He says, "We need to get away from the old type mine, put in more and better machinery . . . " Of course modern mines can pay higher wages. But the benefits of better management and equipment will be lost in great part if the mines enjoying them have to curtail to let poorer mines operate. Under such conditions the incentive to mechanization will disappear, the improvement of productivity will dry up, and the ability of producers to keep coal prices abreast of those of competitve fuels will be further weakened.

The coal industry is not the only one which is concerned with these principles. Since colonial days the number of persons engaged in agriculture relative to the rest of the population has

been reduced by the movement of people from the farms to work in the industries and services. If this shift had not occurred, the result would have been a constant and aggravated over-production of farm products and the sharing of an inadequate income by an excessive number of people, which would be a sharing of misery. At the same time the growth of the industries and services, which has depended upon the movement of people into them from the farms, would have been impossible. Many of the present government farm programs embrace this basic error. They hold umbrellas over inefficient producers. To avert market gluts they require efficient producers to curtail equally with the inefficient, and in some cases more.

In the coal situation the issues and principles are fundamental. Assuming that Mr. Lewis, since coal stocks have been reduced to a point where he feels he has recaptured his bargaining power, will now bargain in good faith, he should not be allowed again to usurp the function of management to the extent of saying how many days a week a given mine is to be allowed to operate.

Influences for Caution

Apart from the possibility that strikes may disrupt the industries, any tendency toward pessimism in business usually relates only to the longer view. In some quarters there is fear that inventories will again be built up excessively. Possibly this is a danger in a few consumers' goods markets, for considerable swings, based largely upon rising and falling inventories, seem to be inherent in the nature of some of these industries. In general, however, both merchants and industrial buyers continue to follow conservative policies. The National Association of Purchasing Agents says its members are generally holding their coverage to 90 days, with 74 per cent not buying beyond 60 days, and that in most commodities the supply and price outlook makes longer coverage unnecessary. In merchandising the pressure of rising costs is a powerful influence directing emphasis toward closer inventory control and increased turnover.

Estimates of the longer outlook in themselves induce caution. Business expenditures on plant and equipment are in a mild downtrend. Some shrinking of exports seems in prospect. Most forecasters, governmental and private, expect a decline in farm income. During January the McGraw-Hill Publishing Co. has published the results of its annual survey of plant and equipment expenditures, which indicates a drop of 13 per cent in 1950 as compared with 1949. This is a moderate decline, and it can refer only to present intentions; it is quite conceivable that programs will be expanded if the business news of the next three months turns out as excellent as it may. Nevertheless, the three influences cited will tend to maintain a degree of conservatism from which the general situation will benefit.

Federal Budget and Tax Proposals

The country now has before it the Administration's budget of government receipts and expenditures for the fiscal year ending June 30, 1951, together with its proposals for reducing certain excise taxes, removing "inequities" in the tax structure, and turning the tax screws a little tighter on the corporations and on gifts and estates. Briefly stated, what the President's recommendations add up to is more spending and taxing, and still another year of an unbalanced budget.

In transmitting the budget to the Congress, the President described it as

> an expression, in financial terms, of the actions this Government can and should take at this time to build toward economic growth and the expansion of human freedom, in our own country and in the world.

Put more bluntly, this is the bill that has to be paid for one year of carrying out the "actions" and programs outlined in the President's State of the Union message and his Economic Report.

This bill for government services comes to an estimated $42.4 billion – less than $1 billion under the estimated cost for the current fiscal year ending in June, and otherwise the biggest since the fiscal year 1946, which included a month and a half of actual shooting war.

The President expects revenue receipts to reach $37.3 billion at existing tax rates, or about half a billion under those estimated for this fiscal year. Compared, however, with planned expenditures, even these enormous receipts – amounting to more than seven times those of 1939 – fall far short of promising a balanced budget. With the indicated excess of expenditures over receipts aggregating $5.1 billion, the country faces its third successive year of deficit financing, the 1951 figure comparing with an estimated $5.5 billion this year, and an actual $1.8 billion in fiscal '49.

In these circumstances, the President's recommended increase of $1 billion net in ordinary tax revenues constitutes hardly more than a gesture towards halting the succession of Treasury deficits and rise of the public debt. In fact, deficit financing, as the long-term table shows, appears now to have become chronic. In only two of the

twenty-one fiscal years, 1931-1951 inclusive, has the Federal Government — despite the steep increase in taxes — been able to live within its income. During that period the public debt will have been increased from $16 billion to an estimated $264 billion, or by more than sixteen times.

United States Government Budget Receipts, Expenditures, and Public Debt, 1914-1951
(In Millions of Dollars)

Year Ended June 30	Total Net Receipts	Total Net Expenditures	Net Surplus or Deficit	Public Debt June 30
1914	$ 735	$ 735	$ 0	$ 1,188
1915	698	761	— 63	1,191
1916	783	734	+ 48	1,225
1917	1,124	1,978	— 853	2,976
1918	3,665	12,697	— 9,032	12,244
1919	5,152	18,515	—13,363	25,482
1920	6,995	6,403	+ 291	24,299
1921	5,625	5,116	+ 509	23,977
1922	4,109	3,373	+ 736	22,963
1923	4,007	3,295	+ 713	22,350
1924	4,012	3,049	+ 963	21,251
1925	3,780	3,063	+ 717	20,516
1926	3,963	3,098	+ 865	19,643
1927	4,129	2,974	+ 1,155	18,512
1928	4,042	3,103	+ 939	17,604
1929	4,033	3,299	+ 734	16,931
1930	4,178	3,440	+ 738	16,185
1931	3,190	3,652	— 462	16,801
1932	2,006	4,741	— 2,735	19,487
1933	2,080	4,681	— 2,602	22,539
1934	3,116	6,745	— 3,630	27,053
1935	3,800	6,592	— 2,791	28,701
1936	4,116	8,541	— 4,425	33,779
1937	5,029	8,706	— 2,777	36,425
1938	5,855	7,031	— 1,177	37,165
1939	5,103	8,966	— 3,862	40,440
1940	5,296	9,206	— 3,910	42,968
1941	7,227	13,387	— 6,159	48,961
1942	12,696	34,187	—21,490	72,422
1943	22,201	79,622	—57,420	136,696
1944	43,892	95,315	—51,423	201,003
1945	44,762	98,703	—53,941	258,682
1946	40,027	60,703	—20,676	269,422
1947	40,043	39,289	+ 754	258,286
1948	42,211	33,791	+ 8,419	252,292
1949	38,246	40,057	— 1,811	252,770
1950 Est.	37,763	43,297	— 5,533	258,400
1951 Est.	37,306	42,439	— 5,133	263,800

Net receipts since 1939 shown after deducting tax refunds. Expenditures for international aid distributed on basis of actual disbursements.

All this is exclusive of receipts and expenditures of the social security and other government trust funds, handled outside the regular budget, which would rise sharply under the proposed legislation for broadening and liberalizing the old-age insurance program and for inaugurating a new program of medical care insurance. The total of these extra budgetary outlays would, if approved by the Congress, reach $5.9 billion in fiscal '51, establishing a new high but for the inclusion this year of the non-recurring $2.8 billion refund being paid to veterans from the veterans' life insurance fund.

At the same time, trust fund receipts, including social security taxes which are largely in excess of social security benefit payments at the present time, would, under the program, rise by $2 billion next year to a new high total of $6 billion.

A Perilous Trend

The question is, where is all this taking us? Though already the burden of taxation on the American people and on business is so great as to discourage incentive and seriously threaten the availability of risk capital for enterprise, yet the President proposes still more government spending and taxing.

Though the country is riding high on the wave of prosperity when, by all the rule books, the Government ought to be showing a surplus of revenue and paying off debt, yet the budget remains unbalanced and the debt gets bigger and bigger.

Clearly, we are embarked on a perilous course.

Where the Money Goes

In the following table we give the estimated expenditures for fiscal '51 by major classifications listed in the budget, together with the original and latest estimates for fiscal '50 and the actual expenditures for fiscal '49. The table is divided to show expenditures often referred to as for "war and aftermath of war", as distinguished from those for all other purposes.

U. S. Budget Expenditures by Major Programs
(In Millions of Dollars)

	1949	Est. 1950 Jan. '49	Est. 1950 Jan. '50	Est. 1951
National defense	$11,914	$14,268	$13,148	$13,545
Veterans' services, benefits	6,669	5,496	6,905	6,080
Interest on public debt	5,852	5,450	5,725	5,625
International affairs	6,462	6,709	5,964	4,711
Subtotal—natl. defense, etc.	30,397	31,923	31,742	29,961
Social welfare, etc.	1,907	2,358	2,297	2,714
Natural resources	1,512	1,861	1,845	2,218
Agriculture	2,512	1,662	2,671	2,206
Transp., communication	1,622	1,586	1,894	1,682
Housing development	282	388	1,006	1,329
General government	1,170	1,224	1,223	1,267
Education, and research	70	414	125	434
Labor	193	187	219	243
Finance, commerce, industry	120	107	225	212
Reserve for contingencies	—	150	50	175
Adjustment	+ 272	—	—	—
Subtotal—all other	9,660	9,935	11,555	12,478
Total expenditures	$40,057	$41,858	$43,297	$42,439

It will be seen that, as the President points out, estimated expenditures next year for "war and aftermath" come to some $30 billion, or 71 per cent of the total budget. This represents a decline of $1.8 compared with expenditures now estimated for this year, and reflects the tapering off of the foreign aid program and drop of some $800 million in estimated payments to veterans. It will be observed, however, that this year's expenditures for veterans are turning out to be considerably above those contemplated in the budget a year ago, due partly to Congressional action in upping benefits and in rejecting certain economies recommended by the President, notably the cutting back of unneeded hospital construction.

Perhaps the most signal achievement revealed by the table is the success of Secretary of Defense Johnson, supported by the President, in

holding down the national defense budget against terrific pressures. Reflecting progress toward unification and vigorous action taken to improve efficiency and lower costs, the Secretary accomplished a slash of more than $1 billion in defense outlays this year from the original budget estimates. These economies, which included the release of some 140,000 civilian employes of the defense establishment since last Summer, were brought about, the Secretary said, without loss of military efficiency. They bear out the findings of the Hoover Commission as to the need for a great deal of tightening up in the military services, and are an effective answer to those who take for granted the untouchability of any expenditure labelled national defense, veterans, etc.

Although the national defense budget for '51 is $400 million higher than the revised estimate for this year, the increase is due in part to the payment of certain earlier authorizations. Secretary Johnson has pointed out that were it not for the economies recently instituted, the budget for '51 would be at least $1.5 billion higher.

Other Costs Rising

Expenses other than those for "war and aftermath" amount to $12.5 billion for fiscal '51, or about 29 per cent of the total budget. There has been a repeated tendency in budget messages to emphasize how the budget is "dominated" by the requirements of paying for past wars and achieving peace in the future, and – by contrast – to minimize the scope of the government spending for all other purposes. The fact is that not only is the latter far more than the entire budget before the war, but it is in this area that the upward trend of expenditures has been most pronounced. The accompanying table and chart reveal the trend since 1947:

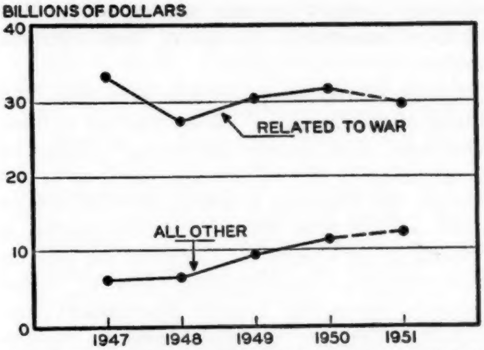
U. S. Government Expenditures Other Than Those Related to War, by Fiscal Years

(In Millions of Dollars)

1947	$6,103
1948	6,293
1949	9,660
1950 Est.	11,555
1951 Est.	12,478

As the previous table of expenditures by major programs reveals, every main classification in this "all other" group shows for '51 increases over the original budget estimates for '50, and all but three show increases over the revised estimates for '50. The two principal exceptions are Agriculture, and Transportation and Communication; and even these two are highly problematical.

The indicated decrease for Agriculture from the record $2.7 billion outlay this year is predicated on the assumption that the cost of support-



U. S. Government Expenditures Related to War, and All Other Expenditures, by Fiscal Years.

ing prices of farm products will be $600 million less next year, but it is admitted that actual outlays will depend upon the weather, changes in domestic and foreign demand, and other factors difficult to forecast accurately. In fact, the Congress is now being asked to increase the authorized borrowing capacity of the Commodity Credit Corporation by an additional $2 billion to a total of $6¾ billion. The Congress is also being asked to put into effect the Brannan plan, the cost of which is unknown and may be astronomical.

The indicated decrease for Transportation and Communication presupposes that the Congress will grant the requested rise in postal rates to yield additional revenues of approximately $395 million annually. Unless this is done, the total, which includes the postal deficit, would rise to a new postwar high.

The biggest increase is in expenditures for housing developments, which in two years have skyrocketed from $300 million to $1.3 billion annually. This reflects mainly the expansion in outlays by the Federal National Mortgage Association (subsidiary of the Reconstruction Finance Corporation) for the purchase of home and rental housing mortgages, made through private lending institutions and guaranteed by the Federal Housing Administration or the Veterans Administration.

The purpose of this program was to provide a secondary market for mortgages in order to aid veterans and others in the financing of new homes. Theoretically, the F.N.M.A. is supposed to provide just a "temporary" market, on the revolving fund principle, but actually it hasn't worked out that way, and this government agency has become a dumping ground for mortgages which private lenders don't want to hold, either because they are of doubtful character or because – in the case of veterans' guaranteed

mortgages – the 4 per cent rate set by the Veterans Administration is out of line with the market.

Already the Government has more than $1.6 billion of the taxpayers' money tied up in these mortgages, and because the present authorized commitment of $2.5 billion may prove to be not enough, the President is asking for $750 million more. At the same time the Administration is pressing a bill before the Congress for still another program – "middle-income housing" – that proposes setting up another government controlled corporation to make loans to middle-income cooperatives at still lower rates – 2½ per cent – to the extent of $2 billion over a period of years. All this is exclusive of the continuing programs for slum clearance, low-rent housing, farm housing, and housing research costing millions of dollars annually in government subsidies. This is at a time when spending for housing, public and private, is booming.

Impediments to Budget Control

In justice to the President, it should be pointed out that the budget message contains many evidences of consciousness of the need for eliminating waste in government and for keeping total expenditures down. The pressures from all quarters for more spending are terrific. Anyone familiar with Washington can well appreciate the President's statement that preparation of the budget "has made necessary the denial of request after request for additional funds which – taken by themselves and in the judgment of particular groups affected – are highly meritorious."

Yet the budget remains big, and threatens to get bigger.

The reasons for this, we suggest, fall into three main categories.

1. The large elements in the budget which are controlled by existing legal and contractual commitments. This includes such items as interest on the public debt, veterans' pensions and benefits, and federal grants to the States under various programs.

Moreover, here we see the cumulative effect of the practice of initiating programs which call for deceptively low "down payments" to begin with, but which mushroom automatically as time goes on.

2. The heavy demands on the Administration and on the Congress to spend more money, or resistance to specific proposals for budget cutting, emanating from the public itself, as all sorts of pressure groups seek to promote or protect their own selfish interests. Too often this includes business groups which on other occasions are loud in their denunciation of "governmental extravagance." As Admiral Forrest P. Sherman, Chief of Naval Operations, recently remarked, taking two destroyers out of the active fleet and putting them in "mothball storage" is a simple task compared to "closing one of two Navy yards in the same State" because of civilian protests resulting from actions of the latter type.

3. By far the most important obstacle to government retrenchment, however, lies in the philosophy running through the budget message that large government expenditures are themselves an essential element in developing economic progress and promoting the welfare of the people.

Though the President, in his budget message, stresses the need for cutting unnecessary costs, yet even in this time of prosperity when, if ever, the economy should be able to stand on its own feet, he is fearful lest "irresponsible and short-sighted" budgetary action contribute to a "decline in production and employment." He warns against "sharp and arbitrary" changes in government programs that "may cause serious damage" to parts of the economy.

The dilemma of the President is clear – a dilemma of wanting to control the budget and at the same time of wanting to use it as an instrument for economic expansion and for distributing benefits to the people. At one point he is "confident" that his fiscal recommendations will result in reduction of expenditures and achievement of a balanced budget "in the next few years". At another he asserts that "federal expenditures are themselves of fundamental importance in our prospects for steady economic growth", and that "this budget (with its $5.1 billion deficit for next year) is not only consistent with an expanding economy, but will make a substantial contribution to that objective."

Unfortunately, the two doctrines don't mix. So long as the latter governs budgetary action, hopes for economy are bound to take a back seat. With the determination of public affairs in the hands of those who regard big government spending as a virtue, the way is open to indulge in extravagances that a nation can ill afford.

How long we can keep this up without precipitating a crisis of some kind is impossible to say. Already a danger signal is flashing when we cannot balance the budget even in prosperous years. Of one thing we can be certain, persistence in loose fiscal practices will bring retribution in the end.

Credit Powers and Inflation Control

The question whether the Federal Reserve needs more powers, or simply more freedom and willingness to use already existing powers, again has been laid before Congress — as it has in every year since the war. Among the legislative recommendations included in the President's annual Economic Report, released January 6, were proposals for giving the Federal Reserve Board broader powers to raise bank reserve requirements "in a period of inflation." The President also asked Congress to put back in force, as a permanent measure, the Board's wartime powers to regulate instalment credit. A few days later, on January 13, the Douglas Subcommittee, which had conducted a study of monetary, credit, and fiscal policies during the Congressional recess, came out with its report. This report endorsed some extensions of Federal Reserve power but placed its primary emphasis on greater vigor and flexibility in the use of already existing powers.

What the President's Economic Report had to say on the question of new credit powers was comparatively brief:

> To carry out the purposes of the Employment Act, the Government should be equipped, as a permanent matter, with the minimum tools necessary to control the basic factors of credit expansion.
>
> To eliminate the competitive disadvantages of Federal Reserve membership, the authority of the Board of Governors of the Federal Reserve System over bank reserve requirements should be revised. The Board should have broader powers than it now has to increase bank reserve requirements in a period of inflation. This would be a protective measure for the entire banking system, and accordingly should be applicable to all banks insured by the Federal Deposit Insurance Corporation.
>
> The Board's authority over instalment credit ended last June. Since that time the excessive relaxation of instalment terms offered to consumers has demonstrated the need for a restoration of the Board's authority.

What this amounts to, in the main, is a restatement of the additional credit powers requested for the Federal Reserve Board in August, 1948 when the Congress was called into an emergency session to take up, among other things, a variety of controls for combatting inflation. Then the extra credit powers were asked on an emergency basis. The powers, partly used, lapsed on June 30, 1949 when price declines and credit contraction indicated that the 1948 inflation surge was ended. Now the similar request for new credit powers is made on a permanent basis.

Inconsistencies of Policy

In light of the general tone of the President's messages, the request for new credit powers to deal with inflation came as something of a surprise. The general theme was one of maintaining plenty of purchasing power and a plentiful supply of credit. Passing mention was made, in the Economic Report, of the rise in instalment credit to a new postwar peak during 1949 with an increase of more than 60 per cent in automobile instalment credit. But no concern was expressed over the much greater rate of expansion, to much higher peaks, in another kind of "instalment credit" — home mortgage financing — which government policy is directed toward continuing if not accelerating. A citizen is justified in wondering why, if the "easy payment plan" is good for acquiring a home, it is not just as good for buying a car to put in the garage and a refrigerator to put in the kitchen. Another seeming conflict of policy is involved in the proposals that, while private lenders may possibly need new curbs, via reserve requirements, lending powers of government agencies need to be enlarged.

The Open Market Power

There should be no disagreement on the principle of having adequate powers at the disposal of the Federal Reserve authorities. It is, significantly, the common record in Europe that effective restraints on inflation have required central banks to control, cut off or reduce, access to their credit-creating powers, to let interest rates rise and bond prices decline, to encourage savers and discourage borrowers. The same principles apply here. This is no more than to recognize that a central bank is a potent instrument of expansion in money and credit. Out of its very nature, a central bank is under a continuing obligation to exercise restraint.

In its final report, the Congressional Subcommittee on Monetary, Credit, and Fiscal Policies wrote:

> The essential characteristic of a monetary policy that will promote general economic stability is its timely flexibility. To combat deflation and promote recovery, the monetary authorities must liberally provide the banking system with enhanced lending power, thereby tending to lower interest rates and increase the availability of credit. To retard and stop inflation they must restrict the lending power of banks, thereby tending to raise interest rates and to limit the availability of credit for private and Government spending. And these actions must be taken promptly if they are to be most effective.

These considerations make Federal Reserve open market operations, supplemented as necessary by changes in discount rate charged member banks on advances, the natural instrument for prompt action and fine shadings of Federal Reserve policy. When the Federal Reserve Banks *sell* government securities in the open market they absorb money available for lending or in-

vesting in other ways. When they *buy* they put money in the market that becomes available for lending or investing.

Affects All Lenders and Borrowers

The Federal Reserve authorities have an enormous power in the $17 or 18 billion government securities they hold in their open market account. The effective exercise of the open market power affects all borrowers and all lenders just as a stone thrown into a pool sends out ripples in all directions. The open market power is a general power and it is one uniquely suited to our democratic institutions because it is an impersonal power. The quality of generality, curiously, is the very one that has made the Federal Reserve authorities extremely circumspect in the use of the open market power for cutting down the supply of credit. For the U. S. Treasury, among other borrowers, finds it a little harder and a little more expensive to borrow when the Federal Reserve uses open market policy to put brakes on credit. Government bonds, of the types traded in the open market, as well as other bonds, tend to decline in price.

During the war emergency, the Federal Reserve bought and sold government securities to keep their prices on an even keel, and to insure the success, on a pre-arranged pattern of interest rates, of the Treasury's enormous borrowing operations. In the postwar years the authorities have continued to be preoccupied with running the government securities market and in 1948, when inflation was the major concern, bought up billion after billion of long-term government bonds to peg their prices at or safely above par.

The pervasive generality of the open market power, and its strength, have received abundant testimonial in explanations Federal Reserve officials have given for not slowing up their purchases of government bonds during 1948. For example, Federal Reserve Board Chairman McCabe, in a statement before the Senate Banking and Currency Committee on May 11, 1949, said: "I am convinced that we could not have abandoned our support position during this period without damaging repercussions *on our entire financial mechanism* as well as seriously adverse effects *on the economy generally.*" (Italics ours.)

A majority of the Federal Reserve Bank presidents, in statements to the special Congressional Subcommittee last Fall, favored "a more restrictive monetary and debt management policy" than was actually undertaken in 1946-48. But they expressed themselves as being fully conscious of *"widespread repercussions throughout the economy"* if they had bought fewer government bonds and allowed their prices to decline. There was no question of power but of willingness to take risks involved in the use of power or even in ceasing to exert inflationary pressure.

If the open market power is so general in its effects — and no one has denied that — where then do reserve requirements come in? What is the necessity for giving the Federal Reserve Board, as the President suggests, additional powers to raise reserve requirements of member banks and new powers to regulate the reserve requirements of F.D.I.C. insured banks that are not members of the Federal Reserve System?

What Are Reserve Requirements?

It is proper to ask the question, What *are* reserve requirements? Why does the Federal Reserve Board need more powers to raise them, and power to impose them on banks which are not members of the System?

Any bank has to have substantial cash reserves, because a bank, to be a bank and stay in business must be able to meet withdrawals by depositors, and to meet foreseeable loan demands from customers. Bank lending and investing policies are powerfully influenced by the amount of reserves they hold — paper currency, coins, and deposit balances with other banks — and the terms on which additional reserves can be borrowed. Hence the power of Federal Reserve open market operations and discount rates.

Holding sufficient reserves, to meet both legal requirements and customer requirements, is a basic precept of sound banking. Up to now, the responsibility of keeping certain minimum amounts of reserves on deposit with the Federal Reserve Banks has not been a deterrent to widespread membership in the Federal Reserve System. All the member banks, 6,901 in number, have 85 per cent of the total deposits of all commercial banks in the country. This percentage has never been higher. Nonmember banks run to 7,250 but are generally much smaller institutions. Of these, 6,517 have voluntarily affiliated themselves with the Federal Deposit Insurance Corporation. It is this group which the President would make subject to the Federal Reserve Board's reserve requirement powers.

The System has grown by free choice of State banks to participate in advantages and disadvantages as they see them. For the numerous small nonmember banks the tie-in to the Federal Reserve System comes through correspondent banks in larger cities. Some of these banks, probably, would not be able to carry substantial idle funds with the Reserve Banks and still earn enough

income to justify continuance in business. They doubtless serve useful functions in their communities. It would be an unwarranted impeachment of State and F.D.I.C. supervision to suggest that they are not safely conducted.

Carrying reserves on deposit with the Federal Reserve Banks, instead of in some alternative form, in no way insures the safety of a bank. A bank that carries too much reserves, by choice or regulation, finds it difficult to earn a living for itself, especially in these days of unprecedentedly cheap money. Higher reserve requirements, to a marginal bank, may make the difference between staying in business or liquidating. Under these circumstances, quite naturally, the proposal to make the Federal Reserve scheme of reserve requirements applicable to nonmember banks stirs opposition.

The Case for Higher Requirements

What is the case now for making bank reserve requirements higher? Chairman McCabe suggested in a statement of the special Congressional subcommittee that new power

> may be needed particularly to absorb excessive reserve funds of banks obtained from large gold inflows or return of currency from circulation, and perhaps also from Federal Reserve purchases of Government securities in maintaining orderly markets. Although the Federal Reserve now holds about $17,000,000,000 of Government securities which might be sold to absorb reserves arising from inflows of gold or currency, these inflows could over a period of years be so large as to deplete the System's resources to below a reasonable operating level.

Only by a wide stretch of imagination could it be argued that the $17 billion portfolio of government securities (currently nearer $18 billion) the Federal Reserve Banks now hold, to which can be added a $2½ billion power to raise reserve requirements under the existing law, might be inadequate to offset gold inflow from abroad or a reduction in currency circulation in this country. There are no visible currents pointing to such developments even over a long period of years. Gold inflow, which amounted to $1½ billion in 1948, dried up in 1949, and in recent months has been replaced by an *out*flow. There are no obvious sources of any great inflow particularly since nations overseas are striving to protect and enlarge their reserves. Currency circulation here continues to fall off, as it has since the war, but at a comparatively modest rate of around $600 million a year. Existing powers are vast against any reasonable prospects of gold or currency inflows for years to come.

The third contingency which Chairman McCabe mentions is a horse of a different color. Reserve requirements, he indicates, might have to be raised to mitigate the inflationary effect of "Federal Reserve purchases of government securities in maintaining orderly markets." This seems to suggest that the Federal Reserve envisions a possible return to its self-defeating policies of 1947-48 when the Reserve Board sought — and finally obtained for a temporary period — more powers to raise reserve requirements, in an endeavor to offset the inflationary effect of its vast purchases of government bonds. Allan Sproul, President of the New York Federal Reserve Bank, pointed out the fallacy in this line of approach in answer to the Douglas Subcommittee's questionnaire:

> . . . in my view a request for more powers was sidestepping the real issue, an issue which would have remained, and reemerged, once any new powers had been granted and put in operation. To have raised reserve requirements in an effort to lock up the new reserves created by support purchases would have been only the first step in a chain reaction. Banks would have sold more securities to the Federal Reserve in order to meet the higher requirements, while the attendant loss of earning assets (and other considerations) might have caused them to go on selling Governments in order to obtain funds for use in making profitable loans or purchasing non-Government securities. A further rise in reserve requirements would probably then have led to even more sales of securities to the Federal Reserve.
>
> Meanwhile, member banks alone would have carried the brunt of the attempted restraint, while many nonmember banks and all other financial institutions could have gone on selling Government securities to the Federal Reserve (thereby adding, as well, to bank reserves) and making new loans and investments as long as they were available and attractive . . .
>
> It is doubtful . . . whether the increases in reserve requirements in 1948 did any more than cause the sale to the Federal Reserve banks of an equivalent amount of Government securities — sales which presumably would not have occurred if it had not been for the increase in reserve requirements themselves.

A Vital Lesson

The Federal Reserve's postwar policies did not impress the Congressional Subcommittee on Monetary, Credit, and Fiscal Policies which gave them intensive study during the Congressional recess. The Subcommittee reached the conclusion that the Federal Reserve is powerless to restrict credit in general while supporting the government security market and for two stated reasons:

> (1) All holders of Governments, both individual and institutional, retain complete freedom to buy or to sell at will any or all of these securities, of which their holdings are tremendous. At their own option they may sell these securities to acquire money to spend for consumption, to finance capital purchases, or to lend to others. Any tendency for interest rates on private obligations to rise relative to those on Governments tends to induce investors to sell Governments in order to make funds available to private users.

And (2) in order to prevent yields on Governments from rising above any given level the Federal Reserve must stand ready to buy at those yields all the Government securities that others do not wish to hold. In this way all holders of Governments, not merely member banks, are given access to new money from the Federal Reserve. They get this money by selling Governments, and the cost of the money to them is the yield that they sacrifice on the securities sold. Thus for the Federal Reserve to maintain low yields on Governments by passively purchasing them in unlimited quantities is to assure that money for other uses will continue to be cheaply available in large amounts.

This is a concise statement of the chief lesson of Federal Reserve experience since the war. It needs to be burned into the consciousness of every banker, every legislator, and every government administrator, and in fact everybody else who is interested in economic stability in the United States.

Deposit Insurance Changes

Senator Maybank, Chairman of the Senate Banking and Currency Committee, has introduced a bill into Congress which would raise the limit of Federal Deposit Insurance coverage from $5,000 for any deposit account to $10,000 and at the same time provide a formula under which, beginning with 1949, a portion of assessments levied upon insured banks may be rebated to them. This bill, which has the Administration's endorsement, recognizes that the current assessment rate is excessive in relation to the foreseeable needs of the Federal Deposit Insurance Corporation. Assessments paid in by insured banks since 1935 not only have covered all losses and expenses of the F.D.I.C. but also have enabled the Corporation to accumulate a surplus or reserve of more than a billion dollars for future contingencies.

When the Federal Deposit Insurance Corporation was first created, in 1933, the U. S. Treasury contributed $150 million as an original capital fund and the Federal Reserve Banks put in $139 million. Since 1935, when a temporary plan was supplanted by the permanent plan, the insured banks have been assessed one-twelfth of one per cent of their total deposits each year. This rate gave the Corporation a total assessment intake, from 1935 to 1948, of $904 million. With investment and other income of $244 million, total income ran to $1,148 million. This is nearly fourteen times the $83 million of losses experienced and expenses incurred over this period.

Federal Deposit Insurance Corporation Record
1933 - 1948

Deposit insurance assessments*	$904,300,000	
Investment and other income	244,400,000	
Total income		1,148,700,000
Deposit insur. losses and expenses	25,900,000	
Administrative expenses	56,900,000	82,800,000
Net income added to surplus		$1,065,900,000

*Excludes assessments levied for temporary plan, 1933-34, which were subject to refund.

Currently, assessments are running around $120 million a year, and, with investment and other income included, total income is close to $150 million a year. Administrative expenses are about $5 million a year and losses in the worst year so far (1939) were no more than $8 million.

The quite negligible losses of the F.D.I.C. since its beginning are of course in good part a reflection of prosperous business conditions over the greater part of the period in which deposit insurance has been in operation. But credit is also due to the effectiveness of the F.D.I.C. policy, adopted from the beginning, to reduce its risks by promoting sound operations of its insured banks. The tools have been careful examination of State nonmember banks and use of the Corporation's powers to reorganize banks which get into trouble or to merge their sound assets and deposits into other banks. In this area, as elsewhere, the principle holds that "an ounce of prevention is worth a pound of cure."

The Assessment Rate

The F.D.I.C. assessment rate has come up for increasing discussion as the reserve fund has accumulated year after year. The Chairman of the F.D.I.C., as early as 1940, when its resources were approaching $500 million, suggested that "it might be appropriate soon to give consideration to a reasonable reduction in the rate of assessment paid by banks." The question was laid aside during the period of war, and wartime deposit expansion led the F.D.I.C. officials to double their conception of what an appropriate reserve would be. After the $1 billion mark had been reached, in 1947, the Congress, at the suggestion of the F.D.I.C., passed a law which halted further accumulation until the Government's $150 million capital stock, and the Federal Reserve's $139 million, had been redeemed, the funds being paid over in both cases to the U. S. Treasury. The Congress at the same time authorized the Secretary of the Treasury to lend to the F.D.I.C., as required for insurance purposes, up to $3 billion. This gave the F.D.I.C. potential resources of $4 billion. The $289 million payments to the Treasury were completed in 1948 and at the end of that year, as the preceding table shows, the surplus or reserve was $65,900,000 beyond the $1,000,000,000 target.

Many bankers have favored suspension of assessments as long as the insurance fund exceeds

$1 billion. Not only does this amount seem more than adequate for any probable requirements, but the investment of this sum, built up out of past assessments, provides a return which is double the maximum of F.D.I.C. losses and expenses in any year since its start. Under this plan, assessments would be resumed whenever the reserve dipped under $1 billion. It would be a simple and automatic solution which would avoid need to review the question again in a few years' time.

The bill introduced by Senator Maybank, through a formula, would allow a continued substantial growth in the reserve. The assessment rate and collections would be unchanged and amounts needed to cover F.D.I.C. expenses and losses would be charged against them. Three-fifths of any amount left over, after the close of any year, would be refunded to the insured banks in proportion to the assessments levied upon them. Two-fifths of the excess, along with interest and other income would continue to enlarge the reserve fund. With a continued favorable loss experience, the insured banks could, under this formula, obtain at least a partial relief from a charge which has proven to be higher than necessary and which has reduced the capacity of the banks to strengthen their own capital funds. The Maybank bill would also make some technical improvements in the law, defining "deposits" more clearly and the responsibility of insured banks to the Corporation.

The Insurance Limit

One other step, favored by many smaller banks, has been an increase in the deposit insurance limit, for any single depositor, from the present $5,000 to $10,000, and such a provision is included in the Maybank bill. Any shift toward acceptance by the F.D.I.C. of legal responsibility for insuring all deposits, without restriction, meets strong objections. The F.D.I.C. was designed primarily for the protection of the great numbers of small depositors. Deposits above $5,000 are not small deposits. Moreover, the need to command confidence to get deposits is a fundamental principle of sound banking. Legislation should not be framed which weakens the incentive to bankers to manage their affairs well in order to gain, hold, and strengthen the confidence of the depositor. This principle is recognized by moderate sized banks as well as large ones. For example, Lon C. McCrory, President of the Citizens State Bank of Dalhart, Texas, in answer to the Douglas subcommittee's questionnaire last Fall, expressed doubt as to the wisdom of a greater coverage than the present $5,000. "When deposits are insured," he said, "it has a tendency to place all banks on an even footing so far as a choice by the customer is concerned."

The most plausible reason for doubling the deposit insurance limit is that the dollar has shrunk by nearly fifty per cent in purchasing power since 1934; thus $10,000 in 1948 dollars is not much more than the equivalent of $5,000 in 1934 dollars. The number of accounts affected by the change would be fractional. Accounts not fully insured today (with balances in excess of $5,000) amount to only 4 per cent of total deposit accounts in insured banks. The $10,000 limit would leave 1½ per cent not fully insured. Doubling the insurance limit would raise the F.D.I.C.'s potential liability from 45 per cent of total deposits in insured banks to 52 per cent.

During the hearings on the bill there was general acceptance of the proposition that the assessment rate could and should be eased. Thomas B. McCabe, Chairman of the Federal Reserve Board, and A. L. M. Wiggins, former Undersecretary of the Treasury and Chairman of the Bank of Hartsville, South Carolina, expressed the view that a more liberal relief from the assessment burden could be allowed with safety. Senator Vandenburg, a sponsor of the original F.D.I.C. legislation, endorsed a reduction in the assessments but opposed the increase from $5,000 to $10,000 in the limit of insurance on any one account. John W. Snyder, Secretary of the Treasury, and Maple T. Harl, Chairman of the F.D.I.C., approved both changes as proposed in the bill, which at this writing is still before the Senate Banking and Currency Committee.

THE NATIONAL CITY BANK OF NEW YORK

Printed in U. S. A.